

Message Text

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ACTION AID-59

INFO OCT-01 NEA-10 ISO-00 CIAE-00 COME-00 EB-07 FRB-03

INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02 OPIC-03 SP-02

CIEP-01 LAB-04 SIL-01 OMB-01 DODE-00 PM-03 H-02 L-02

NSC-05 PA-01 PRS-01 SS-15 IO-10 ABF-01 TAR-01 STR-04

CEA-01 AGR-05 /158 W

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P R 210420Z MAY 75

FM AMEMBASSY DACCA

TO SECSTATE WASHDC PRIORITY 6810

INFO AMEMBASSY NEW DELHI

USMISSION USOECD PARIS 235

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EO 11652: N/A

TAGS: EAID, EFIN, EAGR, BG

SUBJECT: BANGLADESH DEVALUES: PRELIMINARY COMMENT

REF: A. DACCA 2421 B. STATE 115715

1. DEVALUATION IS MOST DRAMATIC STEP IN ECONOMIC STABILIZATION PROGRAM AND DEVELOPMENT PACKAGE STILL BEING NEGOTIATED WITH IMF TEAM IN DACCA. WE EXPECT BDG LETTER OF INTENT TO IMF TO BE SIGNED LATE TODAY (MAY 20) OR TOMORROW AND THAT WE WILL BE ABLE REPORT MORE FULLY ON PACKAGE LATER THIS WEEK.

2. DEVALUATION ITSELF MAY BE EXPECTED TO HAVE FOLLOWING MAJOR EFFECTS.

(A) IT HAS GIVEN BANGLADESH A "MORE REALISTIC" EXCHANGE RATE AND ONE WHICH REFLECTS THE VERY SHARP PRICE RISES OVER THE PAST TWO YEARS. WHILE DEVALUATION
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AT 58 PERCENT, ALBEIT ACCEPTABLE, IS NOT, REPEAT NOT,

WE UNDERSTAND, AS DEEP AS IMF HAD FIRST SOUGHT. OF COURSE, NONE OF THE ARGUMENTS FOR DEVALUATION INCLUDED ANY IDEA THAT THERE WAS A UNIQUE RATE WHICH WOULD SECURE A BALANCE IN THE BDG BALANCE OF PAYMENTS. THIS COUNTRY MAY BE EXPECTED TO REQUIRE CONTINUED SIZABLE AID INFLOWS FOR QUITE SOME TIME TO COME. HOWEVER, CONTINUING TO PEG TAKA TO POUND STERLING, WHICH HAS RECENTLY DECLINED FROM \$2.40 TO \$2.30, HAS BROUGHT CHANGE IN DAILY RATE TO ABOUT 60 PERCENT AND ANY FURTHER DECLINE WOULD INCREASE THIS PERCENTAGE.

(B) DEVALUATION BY THIS AMOUNT WILL CERTAINLY HAVE MAJOR IMPACT ON SUPPLY SIDE ON JUTE CULTIVATION AND PROCESSING AND THUS CONTRIBUTE TO SUSTAINING AND INCREASING MAJOR SOURCE (80 PERCENT) OF BANGLADESH'S EXPORT EARNINGS.

(C) DEVALUATION PERMITS SOME LIBERALIZATION OF FOREIGN EXCHANGE CONTROLS. WITH DEVALUATION, GOVERNMENT SIMULTANEOUSLY ANNOUNCED DISCONTINUATION OF HOME REMITTANCE SCHEME, WHICH PERMITTED OVERSEAS BANGALEES TO REMIT FUNDS ABOVE OFFICIAL RATE, AND ELIMINATION 20 PERCENT IMPORT LICENSING TAX. TAKEN TOGETHER THESE ACTIONS CONTRIBUTE TO DISMANTLING WHAT WAS, WITH THE EXPORT SUBSIDIES ON CERTAIN PRODUCTS, EFFECTIVELY A MULTIPLE EXCHANGE RATE SYSTEM.

(D) DEVALUATION WILL ALSO, OF COURSE, RAISE THE TOTAL COST OF IMPORTED GOODS WHICH PARTICULARLY IN THE CASE OF CAPITAL GOODS, AT THE RELATIVELY CHEAP PRE-DEVALUATION PRICE HAS DISTORTED ECONOMIC DECISION-MAKING HERE.

(E) FURTHERMORE, AS MANY IMPORTED GOODS COULD BE SOLD IN BANGLADESH AT PRICES REFLECTING THEIR SCARCITY VALUE, RATHER THAN THEIR IMPORT COST, LARGE PROFITS COULD BE MADE BY IMPORT LICENSE HOLDERS. THIS MADE THE IMPORT LICENSE SYSTEM PARTICULARLY PREY TO CORRUPTION. DEVALUATION SHOULD BOTH HELP REDUCE THIS SOURCE OF CORRUPTION, AND ALSO ENABLE BDG TO CAPTURE MAJOR PORTION OF DIFFERENCE BETWEEN PRE-DEVALUATION COSTS AND SCARCITY PRICES AT WHICH SUCH GOODS WERE SOLD.

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3. IT IS IMPORTANT ALSO TO VIEW DEVALUATION AS PART OF OVERALL AGREED PROGRAM WHICH WE ASSUME WILL INCLUDE MEASURES AFFECTING SUCH AREAS AS:

- (A) PRICING POLICY, INCLUDING REMOVAL PRICE AND DISTRIBUTION CONTROLS
- (B) DEBT MANAGEMENT
- (C) FURTHER FISCAL REFORMS

- (D) FURTHER ACCELERATION DRAWDOWN AID COMMITMENTS
- (E) IMPORT LIBERALIZATION
- (F) REDUCTION AGRICULTURAL SUBSIDIES
- (G) INCREASED DEVELOPMENT EXPENDITURES.

4. MAJOR PURPOSE OF STABILIZATION PROGRAM IS TO INCREASE BDG REVENUES AND HENCE LOCAL RESOURCES AVAILABLE TO FINANCE ECONOMIC DEVELOPMENT PROGRAM. DEVALUATION WILL ENABLE MAJOR BDG EXPORT-ORIENTED INDUSTRIES, ABOVE ALL JUTE INDUSTRY, BUT INCLUDING NEWSPRINT AND TANNERIES, TO OPERATE PROFITABLY. JUTE INDUSTRY SUBSIDY, NOW RPT NOW FINANCED FROM BUDGET, ALONE COSTS TAKA 580 MILLION. PRICE POLICY CHANGES EXPECTED INCLUDE FURTHER USE OF COST PLUS BASIS FOR PRICING OUTPUT BDG NATIONALIZED INDUSTRIES. (RAILROAD AND POSTAL RATES WERE RAISED IN FY 75 BUDGET, BUT SOME OTHER SERVICES, E.G. ELECTRIC POWER, AND PRODUCTS STILL PRICED BELOW COST.) DEBT MANAGEMENT WOULD HELP CONTROL INFLATION, WHILE ADOPTION SUCH TAX REFORMS AS THOSE PROPOSED BY IMF STAFF CONSULTAMK LAST YEAR COULD RAISE ADDITIONAL REVENUE AND DISTRIBUTE TAX BURDEN MORE EQUITABLY. ABOVE ALL, IMPORT LIBERALIZATION WILL FAVORABLY AFFECT TWO MAJOR TAX REVENUE SOURCES: IMPORT DUTIES AND EXCISE TAXES. THIS IS STEP OF MAJOR IMPORTANCE FOR DONORS, WHO HAVE SEEN DEVELOPMENT BUDGETS IN FY 74 AND 75 FINANCED WHOLLY FROM AID INFLOWS.

5. IMF TEAM HAD HOPED SEE BDG ACT NOW TO RAISE ISSUE PRICES OF FOODGRAINS SOLD THROUGH RATION SYSTEM. PARTICULARLY TO GOVERNMENT EMPLOYEES AND URBAN DWELLERS. IT NOW RPT NOW CLEAR THAT BDG HAS NOT LIMITED OFFICIAL USE

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AGREED TO THIS STEP AT THIS TIME. BDG, WE UNDERSTAND, HAD DECIDED TO ELIMINATE SUBSIDIES AT PRE-MAY 17 EXCHANGE RATE AND BRING RATIONED PRICE UP TO WORLD PRICE (BUT STILL BELOW BANGLADESH OPEN MARKET PRICE). NEED, FOLLOWING DEVLUATION, TO ROUGHLY TRIPLE RATIONED RICE PRICE TO BRING IT IN LINE WITH WORLD PRICE WAS SEEN AS TOO INFLATIONARY AND ZOLITICALLY DIFFICULT. THE NECESSITY OF RAISING PAY OF GOVERNMENT EMPLOYEES TO COVER INCREASED COST OF RATIONED FOOD ALSO INFLUENCED NEGATIVE DECISION. THERE IS POSSIBILITY BDG WILL REVIEW THIS DECISION NEXT DECEMBER/JANUARY AND REDUCE FOOD SUBSIDY IF MAIN HARVEST IS "GOOD".

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INFO OCT-01 NEA-10 ISO-00 CIAE-00 COME-00 EB-07 FRB-03

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NSC-05 PA-01 PRS-01 SS-15 IO-10 ABF-01 TAR-01 STR-04

CEA-01 AGR-05 /158 W

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6. CAN BDG BE EXPECTED TO IMPLEMENT SUCH A PROGRAM?
THE IMF IS FULLY PERSUADED OF BDG SERIOUS COMMITMENT
TO IMPLEMENTATION OF ECONOMIC REFORM PACKAGE. IMF
OFFICIALS HERE POINT TO FOLLOWING BDG MEASURES,
ALREADY TAKEN, AS EVIDENCE:

(A) ANTI-INFLATION MEASURES, INCLUDING REDUCTION
OF DEFICIT FINANCING COMMERCIAL CREDIT SQUEEZE
AND DEMONETIZATION. LATEST INFORMATION INDICATES
THAT DEFICIT FINANCING TO DATE THIS FISCAL YEAR HAS
BEEN LIMITED TO MERE TK. 150 MILLION, IN LINE WITH
BDG UNDERTAKING TO IMF LAST SPRING WHEN IT DREW ITS
FIRST TRANCHE;

(B) GOVERNMENT PRICING POLICY. THE GOVERNMENT
HAS ALREADY TAKEN SOME STEPS TO PRICE THE OUTPUT OF
ITS NATIONALIZED CORPORATIONS AT A COST PLUS BASIS;
AND

(C) IMPROVEMENT IN ADMINISTRATION OF FINANCIAL
AND FISCAL POLICIES, INCLUDING THE APPOINTMENT OF
NEW BALNGLADESH BANK GOVERNOR.

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7. THUS, WHILE FULL DETAILS NOT YET SET, BDG IS TAKING A RELATED SERIES OF MAJOR ECONOMIC POLICY MEASURES IN LINE WITH INSTITUTIONAL AND NATIONAL DONORS', INCLUDING US, RECOMMENDATIONS. IN POLITICAL TERMS, BDG, BY TAKING WESTERN ECONOMIC ADVICE, HAS ACKNOWLEDGED INFLUENCE OF THIS MAJOR SOURCE OF ASSISTANCE AND MOVED TOWARD MORE LIBERAL ECONOMIC POLICIES. THESE POLICY MEASURES, TO BE EFFECTIVE, ARE HIGHLY DEPENDENT ON A CONTINUED FLOW OF FOOD AND OTHER IMPORTS, INCLUDING INDUSTRIAL AND AGRICULTURAL RAW MATERIALS. AS MAJOR DONOR US HAS CLEAR OBLIGATION PLAY ITS PART IN SEEING THAT THESE POLICY MEASURES HAVE GREATEST CHANCE OF SUCCESSFULLY PUTTING BDG ON ROAD TOWARD ECONOMIC DEVELOPMENT. WE BELIEVE USG COULD CARRY ITS FAIR SHARE WITH PLEDGE AT PARIS CONSORTIUM MEETING OF RAPIDLY DISBURSING ASSISTANCE AND THAT THIS CAN BE DONE WITHOUT INCREASING OVER-ALL VOLUME OF US AID BY SIMPLY CHANGING THE COMPOSITION OF EXISTING PROGRAMS. BOSTER

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC STABILITY, DEVALUATIONS, CURRENCIES
Control Number: n/a
Copy: SINGLE
Draft Date: 21 MAY 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: MorefiRH
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975DACCA02479
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D750177-1197
From: DACCA
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1975/newtext/t19750528/aaaaazed.tel
Line Count: 247
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION AID
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 5
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 75 DACCA 2421, 75 STATE 115715
Review Action: RELEASED, APPROVED
Review Authority: MorefiRH
Review Comment: n/a
Review Content Flags:
Review Date: 14 MAY 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <14 MAY 2003 by CunninFX>; APPROVED <14 MAY 2003 by MorefiRH>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
05 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: BANGLADESH DEVALUES: PRELIMINARY COMMENT
TAGS: EAID, EFIN, EAGR, BG
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 05 JUL 2006